

MARSHALLS ENERGY COMPANY, INC.

INDEPENDENT AUDITORS' REPORTS ON  
INTERNAL CONTROL AND ON COMPLIANCE

YEAR ENDED SEPTEMBER 30, 2003



INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL  
CONTROL OVER FINANCIAL REPORTING BASED UPON THE AUDIT PERFORMED  
IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Board of Directors  
Marshalls Energy Company, Inc.:

We have audited the financial statements of the Marshalls Energy Company, Inc. (MEC) as of and for the year ended September 30, 2003, and have issued our report thereon dated December 18, 2003. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether MEC's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed one instance of noncompliance that is required to be reported under *Government Auditing Standards*, which is described in the accompanying Schedule of Findings and Questioned Costs (pages 6 and 7) as item 2003-1.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered MEC's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial reporting, which we have reported to management of MEC in a separate letter dated December 18, 2003.

This report is intended solely for the information and use of the Board of Directors, management, the Rural Utilities Service, supplemental lenders, the cognizant audit and other federal agencies and is not intended to be and should not be used by anyone other than these specified parties.

*Deloitte & Touche*

December 18, 2003



INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND INTERNAL CONTROL  
OVER COMPLIANCE APPLICABLE TO EACH MAJOR FEDERAL AWARD PROGRAM  
AND ON THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Board of Directors  
Marshalls Energy Company, Inc.:

Compliance

We have audited the compliance of the Marshalls Energy Company, Inc. (MEC) with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to its one major federal program for the year ended September 30, 2003. MEC's major federal program is identified in the summary of auditor's results section of the accompanying Schedule of Findings and Questioned Costs (pages 6 through 10). Compliance with the requirements of laws, regulations, contracts, and grants applicable to its one major federal program is the responsibility of MEC's management. Our responsibility is to express an opinion on MEC's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about MEC's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on MEC's compliance with those requirements.

In our opinion, MEC complied, in all material respects, with the requirements referred to above that are applicable to its one major federal program for the year ended September 30, 2003.

Internal Control Over Compliance

The management of MEC is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered MEC's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

#### Schedule of Expenditures of Federal Awards

We have audited the basic financial statements of MEC as of and for the year ended September 30, 2003, and have issued our report thereon dated December 18, 2003. Our audit was performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying Schedule of Expenditures of Federal Awards (page 5) is presented for the purpose of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. This schedule is the responsibility of the management of MEC. Such information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, when considered in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of the Board of Directors, management, the Rural Utilities Service, supplemental lenders, the cognizant audit and other federal agencies and is not intended to be and should not be used by anyone other than these specified parties.

*Deloitte & Touche*

December 18, 2003

MARSHALLS ENERGY COMPANY, INC.

Schedule of Expenditures of Federal Awards  
Year Ended September 30, 2003

| Federal Grantor/Pass-Through<br>Grantor's Program Title | Federal<br>CFDA<br>Number | 2003<br>Receipts | Total<br>Funding<br>Available | 2003<br>Expenditures | September<br>30, 2002<br>Available<br>Funds |
|---------------------------------------------------------|---------------------------|------------------|-------------------------------|----------------------|---------------------------------------------|
| <u>U.S. Department of the Interior</u>                  |                           |                  |                               |                      |                                             |
| Compact of Free Association<br>Section 214(a) Energy    | 15.875                    | \$ 1,866,667     | \$ 1,866,667                  | \$ 1,866,667         | \$ -                                        |

The above federal award is passed through RepMar. The Schedule of Expenditures of Federal Awards is prepared on the accrual basis of accounting.

See Accompanying Independent Auditors' Report on Compliance and Internal Control Over Compliance Applicable to Each Major Federal Award Program and on the Schedule of Expenditures of Federal Awards.

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings and Questioned Costs  
Year Ended September 30, 2003

**Section I - Summary of Auditor's Results**

1. The Independent Auditors' Report on the financial statements expressed an unqualified opinion.
2. No reportable conditions in internal control over financial reporting were identified.
3. One instance of noncompliance considered material to the financial statements was disclosed by the audit.
4. No reportable conditions in internal control over compliance with requirements applicable to major federal award programs were identified.
5. The Independent Auditors' Report on compliance with requirements applicable to major federal award programs expressed an unqualified opinion.
6. The audit disclosed findings required to be reported by OMB Circular A-133.
7. MEC's one major program was:

| <u>Name of Federal Program</u>                        | <u>CFDA Number</u> |
|-------------------------------------------------------|--------------------|
| Compact of Free Association:<br>Section 214(a) Energy | 15.875             |

8. A threshold of \$300,000 was used to distinguish between Type A and Type B programs as those terms are defined in OMB Circular A-133.
9. MEC did not qualify as a low-risk auditee as that term is defined in OMB Circular A-133.

**Section II - Financial Statement Findings**

| <u>Reference Number</u> | <u>Findings</u> | <u>Refer Page #</u> |
|-------------------------|-----------------|---------------------|
| 2003-1                  | Coverage Ratios | 7                   |

**Section III - Federal Award Findings and Questioned Costs**

No federal award findings were reported for the year ended September 30, 2003.

MARSHALLS ENERGY COMPANY, INC.

Schedule of Findings and Questioned Costs, Continued  
Year Ended September 30, 2003

Coverage Ratios

Finding No. 2003-1

Criteria: Section 5.4 of the RUS loan contract requires MEC to establish rates to provide revenue sufficient to meet average coverage ratio requirements as follows:

Operating Times Interest Earned Ratio (OTIER) = 1.10  
Operating Debt Service Coverage (ODSC) = 1.10

Condition: During the year ended September 30, 2003, MEC achieved the following average coverage ratios:

OTIER = (1.92)  
ODSC = (0.24)

Cause: The cause of the above condition is that utility rates are not sufficient to provide adequate revenues to comply with the prescribed rates.

Effect: The effect of the above condition is noncompliance with the average coverage ratio requirements as prescribed by Section 5.4 of the RUS loan contract.

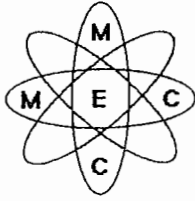
Recommendation: We recommend that management review MEC's rates in order to comply with the average coverage ratio requirements as prescribed by Section 5.4 of the RUS loan contract.

Prior Year Status: Noncompliance with the average coverage ratio requirements as prescribed by Section 5.4 of the RUS loan contract was reported as a finding in the audits of MEC for fiscal years 2000 through 2002.

MARSHALLS ENERGY COMPANY, INC.

Unresolved Prior Year Findings  
Year Ended September 30, 2003

The status of unresolved prior year findings is disclosed within the Schedule of Findings and Questioned Costs section of this report (pages 6 and 7).



## **MARSHALLS ENERGY COMPANY INC.**

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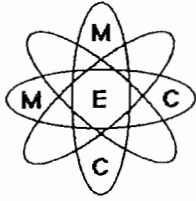
Corrective Action Plans to Questioned Costs and Findings included in the Independent Auditors' Reports on Internal Control and on Compliance for the Year Ended September 30, 2003

### **Financial Statement Findings**

#### Coverage Ratios

#### Finding No. 2003-1

Management continues to monitor and evaluate our operations in order to comply with RUS loan ratios.



## **MARSHALLS ENERGY COMPANY INC.**

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### Summary of Schedule of Prior Audit Findings

Status of audit findings included in the Schedule of Findings for the year ended September 30, 2002:

Finding No. 2002-1 - Not corrected. See corrective action plan to Finding No. 2003-1.

Finding No. 2002-2 - Corrective action has been taken.